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C O N F I D E N T I A L SECTION 01 OF 03 BAKU 001068

SIPDIS

PLEASE PASS COMMERCE DEPARTMENT - DANICA STARKS

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SUBJECT: PRESIDENT ALIYEV, COMMERCE DEPUTY SECRETARY
DISCUSS ECONOMIC, ENERGY COOPERATION

Classified By: Ambassador Anne E. Derse for reasons 1.4 (b) and (d).

11. (C) Summary: President Aliyev told Commerce Deputy Secretary Sullivan October 28 that economic reform and diversification would be among his top priorities in a second term. The GOAJ, while facing lower oil prices and declining revenues, will continue to promote the Azerbaijan Investment Company as a leading vehicle for public investment, particularly in infrastructure and agriculture, and press forward with its ambitious State Investment Program. Foreign investment, the President said, is welcome. The USG recognizes this, Sullivan said, and will re-open an FCS office in Baku. President Aliyev recognized WTO accession as a vehicle for further economic diversification. On energy, Aliyev reaffirmed Azerbaijan's commitment to supply Georgia with natural gas, "even at a loss." Azerbaijan does not use energy resources as a political tool, he said. Aliyev complained of Turkey's intransigence on purchase, pricing and transit issues, and said that Europe remains "passive." The November 13-14 Baku Energy Summit must be about more than Odessa-Brody. End Summary

12. (C) Deputy Secretary of Commerce John Sullivan met with President Ilham Aliyev October 28 to discuss economic cooperation, energy and Azerbaijan's business environment. President Aliyev, whose second inauguration had just taken place following the October 15 presidential election, provided an overview of his administration's second term priorities in terms of economic and social development.

Azerbaijan Investment Company to Lead Development

13. (C) President Aliyev stated that, aside from resolution of Nagorno-Karabakh and regional security issues resulting from the Russia-Georgia conflict, economic reform would be the top priority in his second term. Azerbaijan's goal, he said, would be to reduce dependency on oil and gas revenues by developing non-energy sectors of the economy. To this end, the Azerbaijan Investment Company will continue to be tapped to accelerate development, and would be expected to out-spend domestic and foreign investors. Nonetheless, the President said, foreign investment would be welcomed, as Azerbaijan's economy depends on technology transfer.

14. (C) President Aliyev expects expenditures of the Azerbaijan Investment Fund in fiscal 2009 to reach USD 6 billion. Declines in oil prices, which have led to lower than expected revenues, may cause the GOAJ to scale back

investment plans somewhat, "but not by much." Azerbaijan needs roads, bridges, hospitals, sanitary services, schools, irrigation, etc., the President reported. Azerbaijan's financial sector, the President said, is underdeveloped, but has great potential. Previous investments are already paying off, he said. Sustainable development in non-energy sectors is the goal, and U.S. companies are welcome to invest in Azerbaijan.

FCS to Re-Open in Baku

15. (C) Deputy Secretary Sullivan told President Aliyev that the U.S. Department of Commerce has committed to re-opening its Foreign Commercial Service office in Baku. This step, he said, is an indication of U.S. business interest in Azerbaijan, as well as U.S. Government expectations of continued economic growth in the country. Sullivan simultaneously encouraged President Aliyev to develop a Business Advisory Council, similar to the President's Export Council in the United States, to advance economic reform and stimulate further development. Aliyev noted that he had considered such a formal group in Baku, but had not worked out the proper structure. Aliyev said that his ongoing work with the private sector had already yielded positive results, including some improvements to the business climate that were highlighted in the World Bank's Doing Business report. Sullivan also praised the American Chamber of Commerce's "White Paper" on economic reform, which embassy officers, with AmCham's consent, passed to the GOAJ.

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WTO a Vehicle for Economic Diversification

16. (C) The Deputy Secretary noted Azerbaijan's recent progress on WTO accession, which will be discussed with USTR in Washington following the November 17 meeting of the Economic Partnership Commission. President Aliyev said that WTO membership is important, and would serve as a mechanism to diversify the economy. The President said that his advisors are studying economic models -- particularly those related to resource-rich countries -- looking for successful schemes, and also aiming to avoid mistakes. He noted Azerbaijan's participation in EITI, calling the State Oil Fund (SOFAZ) "a reflection of our successful policies." Some neighboring countries, he said, have stability funds, but transparency does not exist. In Russia, the parliament does not provide adequate oversight and serious reports are not published. In Kazakhstan and Turkmenistan, he said, matters are worse.

Azerbaijan to Supply Georgia with Natural Gas

17. (C) Deputy Secretary Sullivan thanked President Aliyev for Azerbaijan's immediate assistance to Georgia in the aftermath of the August conflict with Russia. President Aliyev noted that discussions were underway to provide Tbilisi with natural gas during the winter season. Azerbaijan, he said, had made a strategic decision to supply Georgia with gas, even though the gas price for Georgia "is less than half the world price." Azerbaijan realizes, however, that sharply higher prices would "bankrupt Georgia," and therefore Azerbaijan will continue "to lose money" in Georgia. "Azerbaijan does not use energy resources as a political tool," the President said. Regional energy philosophy, Aliyev said, must encompass "balance between producers and consumers; energy should never be an instrument of aggression."

Turkey Still Intransigent on Energy Issues

18. (C) Continuing on energy, Aliyev said that Azerbaijan had

not experienced any further progress in negotiations with Turkey. Ankara no longer wants to buy and re-sell Azerbaijan's gas, he said, but the Turks still insist on buying excessive volumes of Shah Deniz II gas. Moreover, a transit agreement to facilitate exports to Europe remains unsettled. Meanwhile, a pricing dispute over existing sales of Shah Deniz I gas continues; six months have passed since the April 15 deadline. Turkey currently pays \$110/thousand cubic meters and has offered an increase to \$144/tcm. "This is not worth discussing," the President said. At this point, Azerbaijan has only two options: continue "worthless" negotiations or seek arbitration.

¶9. (C) Aliyev said that he had met recently with BP executives to discuss longer term options on natural gas development and sales. Turkey is a common concern. "If Ankara remains intransigent," the President said, "then Russia has made an offer." Moscow asks, he said, why Azerbaijan should "mess around with Turkey" and transit issues when Russia is ready to pay market prices. The President noted that he plans to travel to Turkey in early November, and said he would engage his Turkish counterparts directly on a solution. .

¶10. (C) President Aliyev said that relations with Turkmenistan are improving. While in Ankara, he will continue to press the Turks to purchase Turkmenistan's natural gas at its Caspian border. Azerbaijan could then begin efforts to connect production and transport points offshore. Full-scale demarcation of the Caspian Sea, he said, remains much more difficult. The Kyapaz-Serdar offshore field is still in dispute, with Ashgabat demanding 100 percent ownership. Azerbaijan, meanwhile, is ready to share, perhaps through a joint venture in which it would have the minority stake. Overall, the President said, the K-S field looks to be medium size, and therefore the larger picture is not worth sacrificing by setting a hasty

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precedent. Azerbaijan would consider, though, a three-way discussion with Turkmenistan and Turkey on natural gas sales.

Baku Energy Summit

¶11. (C) President Aliyev wants a broad energy discussion at the November 13-14 Baku Energy Summit, with participation of Nabucco partners and others in Europe. "We cannot just talk about a tiny little project with an unclear future like Odessa-Brody," the President said, referring to the ill-fated Ukrainian pipeline. Europe has sent an unclear message on energy cooperation, and remains passive. Some countries within the EU are working simultaneously on Nabucco and South Stream, he complained. Deputy Secretary Sullivan noted that Azerbaijan continues to show important leadership on these issues, and praised Azerbaijan for continuing to work with Kazakhstan on oil transit. As oil production in the North Caspian increases, Aliyev said, "it is natural for Kazakhstan to look in this direction." For that reason, Azerbaijan and Kazakhstan are investing rapidly in ports, terminals and other facilities.

¶12. (C) Comment: Deputy Secretary Sullivan's meeting with President Aliyev came ahead of the reappointment of Azerbaijan's Prime Minister and Cabinet. In following days, Minister of Economic Development Heydar Babayev, who many saw as a leader of reform, was replaced by a senior Ministry of Taxation technocrat, who is largely seen as an ally of the omnipresent Minister of Emergency Situations and former Customs chief, Kamaladin Heydarov. President Aliyev said repeatedly to Deputy Secretary Sullivan that reform will be a top priority in his second administration. The shake-up at the Ministry of Economic Development may have implications on that front. Ministry of Finance Samir Sharifov should be able to shed additional light on Azerbaijan's reform efforts in Washington at the November 17 Economic Partnership

Commission.

¶13. (U) Commerce Deputy Secretary Sullivan did not have a chance to review this cable before departing Baku.

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